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What is "Like Kind"

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WHAT IS "LIKE-KIND"

— by Neil E. Harl*

The popularity of like-kind exchange treatment has grown in recent years as the rules have become more certain¹ and values of assets have risen relative to the income tax basis in those assets. However, a particularly troublesome question for some farm and ranch property is what is considered "like-kind" for purposes of the statutory provision. In particular, concern has been raised over what is considered like-kind for purposes of transfers involving center pivot irrigation systems, specialty storage facilities and similar types of structures.

General rule

The statute merely refers to "...property held for productive use in a trade or business or for investment...exchanged solely for property of like kind."² The regulations distinguish between "real property" and "depreciable tangible personal property."³ As the regulations note, "depreciable tangible personal property" held for productive use in a trade or business or for investment may be exchanged for property of a like-kind or like class.⁴

Unfortunately, the regulations under the like-kind exchange statute, I.R.C. § 1031, do not define "depreciable tangible personal property."⁵ However, the term "personal property" is defined for purposes of I.R.C. § 1245 relating to depreciation recapture as—

"(1) tangible personal property (as defined in paragraph (c), of § 1.48-1, relating to the definition of 'section 38 property' for purposes of the investment credit), and (2) intangible personal property."⁶

The regulations under I.R.C. § 48, in turn, define "tangible personal property" to mean—

"...any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building.

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Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property."⁷

Center-pivot systems

Based on the language in the regulations,⁸ it is fairly clear that a center pivot irrigation system is depreciable tangible personal property and can be exchanged for property of a like-kind or like class.⁹

Returning to the definition of "tangible personal property" in the regulations,¹⁰ the electrical and plumbing connections of a center pivot system are comparable to those of a gasoline pump or a hydraulic car lift, both of which are included as examples in the regulations.¹¹ Moreover, the case law supports the conclusion in comparable settings that such items are "tangible personal property." Thus, the term includes air conditioning units to meet temperature and humidity requirements;¹² propane storage tanks;¹³ photo labs (but not concrete foundations);¹⁴ bulk tanks and storage tanks used in bulk petroleum distribution and retail operations;¹⁵ fire extinguishers;¹⁶ fixed or floating docks (but not pilings);¹⁷ construction site trailers;¹⁸ billboards, signs, lighting fixtures and detachable poles at retail gas stations (but not concrete foundations);¹⁹ and bank vault doors, record vault doors, night depository facilities and walk-up and drive-up teller's windows (but a drive-up teller's booth was a building).²⁰

As for what is "like-kind" for depreciable personal property, depreciable personal property is classified into 13 general asset classes.²¹ The classes are listed in the IRS publication for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4.²² Depreciable personal property that is not classified with any of the 13 general asset classes is classified into four digit product classes.²³ Properties within the same product class generally are of a like class.²⁴ Much of the personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment. Thus, an exchange of farm machinery for farm machinery is like kind.

Specialized storage structures

The like-kind exchange treatment of specialized storage structures and similar facilities is less straightforward.

The regulations state that "one kind or class of property may not, under I.R.C. § 1031 be exchanged for property of a different kind or class."²⁵ If a specialized storage structure (or similar facility) is deemed to be real property, the structure may be exchanged for other real property.²⁶ A structure classified as a "building" should be eligible for such exchange treatment as real property.

By contrast, a structure classified as "depreciable tangible personal property" should be exchangeable in a like-kind transfer under the general asset class rules or the product class rules.²⁷ There is, indeed, some authority indicating that a specialized storage structure could be so classified, with the classification decision dependent upon the facts and circumstances of each situation. It is pointed out that various courts have stated that the term "tangible personal property" is not to be defined narrowly and includes "assets necessary to the operation of a business."²⁸ Thus, photo labs (but not their concrete foundations) have been held to be tangible personal property.²⁹ Construction site trailers have been held to be tangible personal property.³⁰ In contrast, a bank teller's booth has been held not to be depreciable personal property but rather

was deemed to be a building.³¹ The question is not so much an issue of the functional use of the structure, but whether the structure is a permanent improvement to the land.³²

The "other property" classification

The remaining question is the proper classification for like-kind exchange treatment purposes of structures and other property coming within the "other property" category of I.R.C. § 1245.³³ The like-kind exchange regulations do not address that issue, unfortunately. There is no doubt that specialized storage structures and like kinds of facilities are eligible for like-kind exchange treatment so long as held for productive use in a trade or business or are held for investment.³⁴ The question is one of classification.

There is no evidence that Congress intended to embrace the "other property" branch of I.R.C. § 1245³⁵ for purposes of the like-kind exchange rules.³⁶ The reason reliance was placed on I.R.C. § 1245 was that the regulations under I.R.C. § 1031 refer to "personal property" and "depreciable tangible personal property."³⁷ I.R.C. § 1245(a)(3)(A) refers to "personal property." At no point is reference made to "other property" (or to I.R.C. § 1245(a)(3)(B)) in the like-kind exchange statute or the regulations. Moreover, no ruling or case has been located that incorporates I.R.C. § 1245(a)(3)(B) (the "other property" provision) into the like-kind exchange rules.

Further, there appears to be no compelling policy reason for including the "other property" language in the like-kind exchange rules. As the Seventh Circuit Court of Appeals has stated,³⁸ the tests for "other property" are—(1) the property must qualify initially as tangible property of the type intended by Congress to be covered; (2) it must not be a building; and (3) it must not be a structural component of a building. Quite clearly, tests 2 and 3 are not important in classifying specialized structures; test 1 is arguable important. However, no evidence has been located that Congress intended to include the "other property" provision under I.R.C. § 1031.

If the "other property" provision is not incorporated into the like-kind exchange rules, and a particular structure is neither real property (a building) nor depreciable personal property, then taxpayers are left with some uncertainty as to what constitutes "like-kind" property. The safe approach is that such a structure could be exchanged for similar kinds of structures without recognition of gain.

In conclusion

Obviously, more guidance is needed in the form of rulings, cases or additional regulations before the breadth of opportunity for like-kind exchange treatment of specialized structures will be known with certainty.

FOOTNOTES

¹ See generally 4 Harl, *Agricultural Law* § 27.03[8][a][ii] (1998); Harl, *Agricultural Law Manual* § 4.02[16] (1998).

² I.R.C. § 1031(a)(1).

³ Treas. Reg. §§ 1.1031(a)-2(b)(1), 1.1031(a)-1(b).

⁴ Treas. Reg. § 1.1031(a)-2(b)(1).

⁵ See Treas. Reg. § 1.1031(a)-2(l).

⁶ Treas. Reg. § 1.1245-3(b).

⁷ Treas. Reg. § 1.48-1(c).

⁸ *Id.*

⁹ Treas. Reg. § 1.1031(a)-2(b)(1).

¹⁰ Treas. Reg. § 1.48-1(c), n. 7 *supra*.

¹¹ *Id.*

- ¹² Texas Instruments, Inc. v. Comm'r, T.C. Memo. 1992-306.
¹³ Rev. Rul. 83-146, 1983-2 C.B. 17.
¹⁴ Fox Photo, Inc. v. Comm'r, T.C. Memo. 1990-348.
¹⁵ Siler v. Comm'r, T.C. Memo. 1985-257.
¹⁶ Rev. Rul. 67-417, 1967-2 C.B. 49.
¹⁷ Estate of Morgan v. Comm'r, 448 F.2d 1397 (9th Cir. 1971).
¹⁸ Rev. Rul. 77-8, 1977-1 C.B. 3.
¹⁹ Rev. Rul. 80-151, 1980-1 C.B. 7.
²⁰ Rev. Rul. 65-79, 1965-1 C.B. 26.
²¹ Treas. Reg. § 1.1031(a)-2(b)(2).
²² Rev. Proc. 87-56, 1987-2 C.B. 674.
²³ See Treas. Reg. § 1.1031(a)-2(b)(3), Standard Industrial Classification Manual (SIC Manual), Office of Management and Budget (1987).
²⁴ Treas. Reg. § 1.1031(a)-2(b)(1).
²⁵ Treas. Reg. § 1.1031(a)-1(b).

- ²⁶ Treas. Reg. § 1.1031(a)-1(c)(2).
²⁷ Treas. Reg. § 1.1031(a)-2(a). See ns. 21-24 *supra*.
²⁸ E.g., Texas Instruments, Inc. v. Comm'r, T.C. Memo. 1992-306.
²⁹ Fox Photo, Inc. v. Comm'r, T.C. Memo. 1990-348.
³⁰ Rev. Rul. 77-8, 1977-1 C.B. 3.
³¹ Rev. Rul. 65-79, 1965-1 C.B. 26.
³² See Rev. Rul. 77-8, 1977-1 C.B. 3.
³³ See I.R.C. § 1245(a)(3)(B).
³⁴ I.R.C. § 1031(a)(1).
³⁵ See I.R.C. § 1245(a)(3)(B).
³⁶ See Treas. Reg. § 1.1245-3(c)(1).
³⁷ Treas. Reg. § 1.1031(a)-2(c).
³⁸ Illinois Cereal Mills, Inc. v. Comm'r, 789 F.2d 1234 (7th Cir. 1986), *aff'g*, T.C. Memo. 1983-469.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

HOMESTEAD. The Chapter 13 debtor owned a one-half beneficial interest in a trust which owned two pieces of real property, one of which was used by the debtor as a principal residence. The interest in the trust had a fair market value of \$24,000 and the debtor claimed \$15,000 as exempt under Section 522(d)(1) as personal property used as a residence. The court held that the exemption was not allowed because (1) the debtor's property consisted only of the beneficial interest in the trust which was personal property, (2) Section 522(d)(1) required a debtor to live in the personal property claimed as a homestead, and (3) the debtor did not live in the beneficial interest in the trust. *In re Bowers*, 222 B.R. 191 (Bankr. D. Mass. 1998).

CHAPTER 12-ALM § 13.03[8].*

CHAPTER 12 BANKRUPTCY EXPIRES

The Congress, on September 30, 1998, failed to take action to extend Chapter 12 bankruptcy. Therefore, the provision is not available after that date. In the last minute discussions on the topic, the House of Representatives refused to allow the Chapter 12 provision to be removed from the pending Bankruptcy Reform Bill. The pending legislation would make Chapter 12 a permanent part of the Bankruptcy Code. Some believe that the larger bill may pass before Congressional adjournment; others are less sure. In any event, those seeking bankruptcy protection after September 30 and until enactment of legislation on Chapter 12 will need to resort to other bankruptcy reorganization provisions, notably Chapters 11 and 13. See Harl, *Agricultural Law*, § 120.08[5][a] (1998); Harl, *Agricultural Law Manual*, § 13.03[8][d][i] for discussion of conversion of Chapter 11 and 13 cases to Chapter 12.

POST-CONFIRMATION BORROWING. The debtor's confirmed plan established the priority of the secured claims allowed in the case. The debtor sought permission to borrow funds for livestock expenses and to grant the lender a superpriority in the debtor's collateral which was subject to first priority liens. The debtor argued that Section 364(d)(1) gave the court authority to grant the superpriority lien. The court held that (1) it had no authority to grant superpriority because Section 364 applied only to estate property and after confirmation all estate property reverts to the debtor, and (2) the plan had established the priority of secured claims and that was binding on the court and debtor. *In re Les Ruggles & Sons, Inc.*, 222 B.R. 344 (Bankr. D. Neb. 1998).

FEDERAL TAXATION-ALM § 13.03[7].*

The Internal Revenue Service has announced that it has undertaken a new initiative to improve its procedures for handling bankruptcy cases. The new procedures are intended to minimize the likelihood that IRS collection actions will inadvertently violate the bankruptcy laws, to facilitate prompt correction of any violations that do occur, and to provide an administrative process for handling any claims for damages against the IRS that arise from such violations. *Ann. 98-89, I.R.B. 1998-___, ___*.

AVOIDABLE LIENS. The Chapter 13 debtor sought to avoid perfected tax liens by arguing that the debtor, acting as trustee, had the power, under Section 545, to avoid liens. Section 545(2) makes the trustee a hypothetical bona fide purchaser of estate property. The debtor argued that, under I.R.C. § 6323, the trustee was a bona fide purchaser of the estate property entitled to a higher priority than the tax liens. The court rejected this argument, although noting that a minority of courts have agreed with the debtor's arguments, and held that the trustee's status as a hypothetical bona fide purchaser was not sufficient to be a bona fide purchaser under I.R.C. § 6323. *In re Stangel*, 222 B.R. 289 (Bankr. N.D. Tex. 1998).